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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1966

No. 417

LOUIS A. KLITZNER and ISABEL S. KLITZNER,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR
THE SIXTH CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONERS

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REFERENCES

1. Pet.	Petition for Certiorari
2. Resp.	Respondent's Memorandum in Opposition
3. R.	Printed Appendix in the Court of Appeals

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In a business transaction in which the sellers of a going business and related assets producing a net profit of over $100,000.00 per year were paid over $1,000,000.00, the purchaser is charging off or expensing over $700,000.00 of the consideration paid because of unilateral write-ups of assets, never agreed to by the Petitioners, and the value assigned to a restrictive covenant.

The allocation of the price paid for the Petitioners' partnership interests was the subject of a tax examination by the Respondent's agent, Mr. Lemons, and a later closing agreement covering the year of sale.

The Petitioners have consistently contended that they are not bound by the purchaser's unilateral treatment of the sale transaction and that the undisputed evidence in the record established the covenant value to be the price paid for the good will of the business.

Petitioners here contend that they have been deprived of substantial rights and that the Trial and Appellate Courts applied erroneous legal standards as to which the Circuits are in conflict and in controversy to the exclusion of material evidence and the elevation of form above substance.

1. The recantation by the Respondent of the words "economic substance" and the words "real economic value," without more, is to rely upon legal ambiguities. Any covenant for which money or money's worth is paid has economic reality or value. These words mean absolutely nothing unless they are made a legal postulate of the covenant in this case by a clear finding of fact as to the value of the good will of the business sold.

This petition would serve no legal purpose if the Respondent or the Trial Court or the Appellate Court had pointed to any specific evidence contained in the record of these proceedings to show that this business had no good will; or, having good will, the value thereof. It would serve no purpose if the Trial Court had considered the totality of the evidence which included testimony offered and introduced by the Petitioners as to the value of the partnership interests sold by them including good will.

In the Tax Court the Respondent relied upon the "separate" and "severable" criteria criticized by the Ninth Circuit. (R. 259a). The Tax Court followed these tests. (R. 288a). The Appellate Court followed these tests. (Pet. 3a-4a),

Petitioners have made a desperate search of this record for evidence connecting the "economics" of the covenant in this case to the "personal characteristics and qualifications" of the Petitioners. Petitioners have also desperately sought to have the Respondent point to the evidence in the record which connects the economics of the covenant in this case to those personal characteristics and qualifications. Respondent did not comply with *Rule 16(4)(b)* of the reviewing Court of Appeals; and, now in this Honorable Court, with all of the proceedings available to it, the Respondent does not point to any evidence in the record in support of any determinative finding by the Trial Court as to the value of the good will of the business sold which would close the case against Petitioners once and for all. Respondent has not and cannot, because the only evidence as to the value of good will contained in this record supports a determination in favor of the Petitioners. Respondent, therefore, relies upon the general and conclusory and unsupported decision of the Trial Court from which it extracts disconnected conclusory expressions drawn at random from a confusion of cases.

The naked truth is that the Respondent, the Trial Court and the Appellate Court applied erroneous legal standards, out of the hodgepodge of decisions rendered in covenant cases, to elevate form over substance and *to the exclusion of material evidence in direct conflict with this Court's decisions in the Court Holding Company, Hansen and Duberstein cases.* (Pet. 13-14, 22-24). The Respondent indirectly admits this departure from the rule of "substance over

form" in its unique description of the legal standard or test being applied in covenant cases. (Resp. 4). Further, the Respondent indirectly admits the conflicts existed within and among the Circuits by stating that the only difference among the Courts is "one of emphasis in phrasing the legal test." (Resp. 4).

Respondent has not undertaken to joust with the authorities cited in the Petition for Certiorari which point up the conflicts and the divergent administration of covenant law in the Circuits. (Pet. 13-17). Petitioners are not content that the Third, Fourth, Seventh and Ninth Circuits would have dealt with their case in the same way the Sixth Circuit dealt with it and as the Fifth Circuit might be expected to deal with it.

The evolvement of the "separate" and "severable" criteria has unnecessarily confused simple contract or covenant law. All this confusion would be eliminated if the Respondent and the Trial Courts, and taxpayers for that matter, seek the answer to one simple fundamental question. What is the value of the good will of the business sold? The answer to this question lays the case to rest. The covenant then has "economic reality" as the value thereof relates to the value of the good will of the business or to the personal characteristics and qualifications of the sellers of the business. Under the Third, Fourth, Seventh and Ninth Circuit cases the result is capital gain or ordinary income or both for tax purposes. Even the Respondent has acceded to this approach in *Rev. Rul. 1960-2 Cum. Bull. 15* (Pet. 15) holding that ordinary income results when covenants are dependent "solely" upon the personal characteristics and qualifications of the seller—a ruling which cries out with Petitioner for a determinative finding of fact based upon evidence by the Trial Court as to the degree of dependency, large or small, of their covenant upon the

good will of their business or upon their personal characteristics and qualifications.

Respondent's analysis of the Trial Court's comments on the nature of linen service businesses (Resp. 3) does not square with the Court's language at R. 294a, or with Respondent's position in *Rev. Rul. 60-301*, supra. Petitioners have failed to find any support for comparable language in any of the prior cases dealing with linen service businesses. (Pet. 19). Further, the recital by the Respondent (Resp. 3) that Petitioners could not solicit former customers and reenter business and were required to execute affidavits precedent to payment applies to the form of any covenant regardless of whether it is realistically related to the good will of the business or to the personal characteristics or qualifications of the sellers.

Bearing in mind that the critical question in covenant cases is whether the covenant embraces the value of good will or the value of personal attributes or both, evidence as to the value of the good will of the business sold is material and relevant to the issue. Petitioners introduced such evidence. (Pet. 25-30). This material evidence was completely disregarded by the Trial Court although it was absolutely undisputed upon the record. The evidentiary requirements for evaluating the good will of any business are well established. Mr. Seidman's testimony was relevant, material evidence as to a critical issue before the Trial Court. Respondent is, therefore, erroneous in its conclusion that the Trial Court or the Appellate Court examined or even considered all the relevant evidence and that the Petitioners had not proven that the covenant lacked economic significance. To the contrary the undisputed evidence of Petitioners established the economic significance of the covenant as being directly related to the good will of the business and the Respondent and the two lower Courts were